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BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE
APPLICATION OF BLACK MOUNTAIN
SEWER CORPORATION, AN ARIZONA
CORPORATION, FOR A
DETERMINATION OF THE FAIR
VALUE OF ITS UTILITY PLANT AND
PROPERTY AND FOR INCREASES IN
ITS RATES AND CHARGES FOR
UTILITY SERVICE BASED THEREON.

DOCKET NO: SW-02361A-08-0609

BLACK MOUNTAIN SEWER CORPORATION

REPLY CLOSING BRIEF

December 22, 2009

Arizona Corporation Commission

DOCKETED

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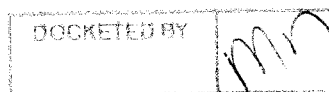


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TABLE OF ABBREVIATIONS AND CONVENTIONS

Black Mountain Sewer Corporation, uses the following abbreviations in citing to the pre-filed testimony and hearing transcripts in this brief. Other documents that were admitted as exhibits during the hearing are cited by hearing exhibit number. The parties' final schedules setting forth their respective final positions will be cited in abbreviated format as follows: BMSC Final Sch. XXX, Staff Final Sch. XXX; RUCO Final Sch. XXX.* Other citations to testimony and documents are provided in full, including (where applicable) the Corporation Commission's docket number and filing date.

BLACK MOUNTAIN SEWER CORPORATION ("BMSC") PRE-FILED TESTIMONY

Pre-Filed Testimony	Hearing Exhibit	Abbreviation
Direct Testimony of Greg Sorensen	A-1	Sorensen Dt.
Direct Testimony of Tom Bourassa (Rate Base)	A-4	Bourassa Dt.
Direct Testimony of Tom Bourassa (Cost of Capital)	A-5	Bourassa COC Dt.
Rebuttal Testimony of Greg Sorensen	A-2	Sorensen Rb.
Rebuttal Testimony of Tom Bourassa (Rate Base)	A-6	Bourassa Rb.
Rebuttal Testimony of Tom Bourassa (Cost of Capital)	A-7	Bourassa COC Rb.
Rejoinder Testimony of Greg Sorensen	A-3	Sorensen Rj.
Rejoinder Testimony of Tom Bourassa (Rate Base)	A-8	Bourassa Rj.
Rejoinder Testimony of Tom Bourassa (Cost of Capital)	A-9	Bourassa COC Rj.

* BMSC filed its Final Schedules on December 10, 2009.

**RESIDENTIAL UTILITY CONSUMER OFFICE ("RUCO")
PRE-FILED TESTIMONY**

Pre-Filed Testimony	Hearing Exhibit	Abbreviation
Direct Testimony of Rodney Moore	R-3	Moore Dt.
Direct Testimony of William Rigsby	R-6	Rigsby Dt.
Surrebuttal Testimony of Rodney Moore	R-4	Moore Sb.
Surrebuttal Testimony of William Rigsby	R-7	Rigsby Sb.

**STAFF
PRE-FILED TESTIMONY**

Pre-Filed Testimony	Hearing Exhibit	Abbreviation
Direct Testimony of Dorothy Hains	S-1	Hains Dt.
Direct Testimony of Juan Manrique	S-3	Manrique Dt.
Direct Testimony of Crystal Brown	S-5	Brown Dt.
Surrebuttal Testimony of Dorothy Hains	S-2	Hains Sb.
Surrebuttal Testimony of Juan Manrique	S-4	Manrique Sb.
Surrebuttal Testimony of Crystal Brown	S-6	Brown Sb.
Supplemental Surrebuttal Testimony of Crystal Brown	S-7	Brown Supp. Sb.

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**BOULDERS HOMEOWNERS' ASSOCIATION ("BHOA")
PRE-FILED TESTIMONY**

Pre-Filed Testimony	Hearing Exhibit	Abbreviation
Direct Testimony of Les Peterson	BHOA-4	Peterson Dt.
Surrebuttal Testimony of Les Peterson	BHOA-5	Peterson Sb.

**TOWN OF CAREFREE ("CAREFREE")
PRE-FILED TESTIMONY**

Pre-Filed Testimony	Hearing Exhibit	Abbreviation
Direct Testimony of Brian Kincaid	Carefree-1	Kincaid Dt.

**DENNIS E. DOELLE, D.D.S. ("DOELLE")
PRE-FILED TESTIMONY**

Pre-Filed Testimony	Hearing Exhibit	Abbreviation
July 2009 Direct Testimony of Dennis Doelle	Doelle-1	Doelle Dt.
September 2009 Direct Testimony of Dennis Doelle	Doelle-2	Doelle Supp. Dt.
Surrebuttal Testimony of Dennis Doelle	Doelle-3	Doelle Sb.

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OTHER PORTIONS OF THE RECORD

Pre-Filed Testimony	Hearing Exhibit	Abbreviation
Decision No. 69164 (December 5, 2006)	BHOA-1	Decision No. 69164
Hearing Transcript November 18-25, 2009	--	Tr.

2266279.6

1 **INTRODUCTION**

2 BMSC hereby responds to the closing briefs filed by the other parties to this rate
3 case.¹ The Company is seeking adjustments to its rates and charges for wastewater utility
4 service, utilizing a test year ending June 30, 2008, that will produce an increase in
5 revenues of \$952,956 (60.31%) over adjusted test year revenues.² This results in a
6 revenue requirement of \$2,533,126, and operating income of \$456,660, which produces a
7 rate of return on the Company's adjusted original cost rate base, \$3,682,741, of 12.4
8 percent.³ The Company's proposed rates to generate this revenue requirement are just and
9 reasonable, and are necessary to allow the Company an opportunity to earn a reasonable
10 return on its investment while continuing to provide a high level of service at a reasonable
11 price. In addition, the Company joins the BHOA in requesting approval of a surcharge
12 recovery mechanism associated with the plant closure requested by the BHOA, and
13 requests approval of a new HUF tariff in the form attached to the Company's brief.

14 **ARGUMENT**

15 **I. REPLY ON REQUEST FOR RELIEF BY BHOA AND BMSC**

16 After taking up much of the hearings, the issue of the relief jointly sought by the
17 BHOA and BMSC is not a prominent feature in the briefs of the other parties. RUCO
18 simply summarizes its argument that it is against a surcharge mechanism because it
19 constitutes extraordinary ratemaking.⁴ RUCO is correct that this situation calls for
20 extraordinary relief, like that proposed by the ratepayers and agreed to by the Company in
21

22 ¹ In this reply brief, BMSC will use the same citation format, abbreviations and conventions as
23 utilized in its initial closing brief dated December 14, 2009. Additionally, the parties' closing
24 briefs will be identified as "Staff Br.", "RUCO Br.", "Town Br." and "BMSC Br.", respectively.
The Company does not have a reply to and agrees with the position taken by the BHOA in its
initial closing brief.

25 ² BMSC Final Sch. A-1.

26 ³ *Id.*

⁴ RUCO Br. at 16:15 – 17:5.

1 this rate case, the same relief opposed by RUCO. For its part, Staff merely asserts that
2 “the circumstances yield no clear choice” but that RUCO’s suggestion that the Company
3 be ordered to invest capital to remove used and useful plant is not a good idea.⁵ The only
4 alternative to RUCO’s suggestion, short of leaving the plant up and running, is the well
5 thought-out and well supported proposal by the BHOA and BMSC. At this stage, there is
6 simply no compelling reason to deny the requested relief, including the cost recovery
7 surcharge mechanism proposed by BMSC.

8 **II. REPLY ON RATE BASE/OPERATING EXPENSE ISSUES**

9 **A. Reply on Staff’s Adjustments to Contractual Services**

10 **1. APIF Cost Allocation**

11 Staff fairly summarizes the role and relationship between APIF, BMSC’s ultimate
12 parent, and Liberty Water, one of the two groups of utility and energy assets owned by
13 APIF.⁶ Staff also accurately summarizes the role of Liberty Water in managing and
14 operating the regulated utilities, including correctly pointing out that Liberty Water
15 employees operating the individual utilities, like BMSC, allocate their time directly to that
16 utility.⁷ It follows that Staff is also correct that the utility subsidiaries, including BMSC,
17 do not have employees.⁸ This isn’t unique, for example the utilities owned in the Global
18 family of companies are operated by Global Water, Inc. under a shared-services model.⁹
19 Still, there is much more in dispute than would appear from Staff’s brief.

22 ⁵ Staff Br. at 26:5-27.

23 ⁶ *Id.* at 7:3-10.

24 ⁷ *Id.* at 7:12-19.

25 ⁸ *Id.* at 7:12.

26 ⁹ See Direct Testimony of Gregory Barber (February 20, 2009), Docket Nos. SW-20445A-09-0077 and W-03575A-09-0077, at 2-5.

1 For one thing, BMSC does not really prefer Staff's alternative methodology for
2 allocating the costs in the APIF cost allocation pool.¹⁰ Staff has changed the number of
3 total facilities that are part of the allocation pool from 63 to 78 by including facilities that
4 were not owned by APIF during the test year.¹¹ Staff has also eliminated any recognition
5 of the disparate impacts of different sized utilities on the total costs contributing to the
6 cost allocation pool. Specifically, after determining that 26.98 percent (17/63) of the
7 allocation pool belonged to Liberty Water, Liberty Water then allocates those costs to the
8 17 separately owned utilities based on customer count.¹² Staff simply allocates these costs
9 to each of the entities under the APIF umbrella equally, meaning LPSCO with 32,000
10 customers has the same cost allocation as BMSC with 2,000 customers.

11 More problematic, however, is the fact that Staff first removed 90 percent of the
12 amount of actual costs incurred allocated by APIF even before getting to how these costs
13 will be allocated.¹³ Staff glosses over this \$3 million adjustment in its brief, but its
14 position seems to be founded largely on Staff's repeated claim that it lacked adequate
15 documentation regarding the APIF cost allocations.¹⁴ This argument is extremely
16 frustrating. Staff propounded and the Company answered dozens of data requests on
17 operating and administrative expenses, including the cost allocations. The Company
18 provided all invoices over \$5,000 relating to these allocated costs and was willing to
19

20 ¹⁰ Staff Br. at 8:13-15 *citing* Tr. at 309. Mr. Sorensen's testimony reflects the Company's
21 position that whether you use 1 out of 63 or 17 out of 63 to derive your allocation ratio, it doesn't
22 matter if you don't then allocate by customer count.

23 ¹¹ Brown Dt. at 17. Some of these facilities were not even owned by APIF before or after the test
24 year, they are simply operated by the parent under an operations agreement.

25 ¹² Bourassa Rb. at 18:10-18.

26 ¹³ Brown Dt. at 16:5-11. This is in addition to Staff's disallowance of nearly \$200,000 of
charitable costs, corporate gifts, etc. The Company has agreed with this adjustment to lower the
allocation pool by \$200,000 since rebuttal. Bourassa Rb. at Sch. C-2, pages 16 and 17; Bourassa
Rj. at Sch. C-2, pages 16 and 17.

¹⁴ Staff Br. at 9:13-23, 9:25 - 10:3.

1 provide any further invoices below that amount upon request. It is unclear exactly what
2 Staff felt was missing, because all Ms. Brown could testify to by way of explanation was
3 that she reviewed some documents and subjectively concluded that 90 percent of the costs
4 had to go.¹⁵

5 Staff's other prominent objection – that the administrative costs allocated by APIF
6 do not reflect direct charges attributable to BMSC, is equally unpersuasive.¹⁶ Contrary to
7 Staff's mistaken belief, APIF is not allocating "personnel" costs to Liberty Water;¹⁷ it is
8 allocating administrative, central office and third-party professionals services costs.
9 These costs are not like the direct labor of an operator that can be allocated to BMSC,
10 LPSCO and a utility in Texas based upon timesheets. These services are incurred entirely
11 for the benefit of the whole group of facilities, both power generation and utilities,
12 therefore the costs are allocated as part of a shared services model. To the extent BMSC
13 benefits from these services less than say LPSCO, that difference is captured in the
14 Company's proposed allocation methodology, in contrast to Staff's which treats 78 assets
15 across North America equally.

16 In summary, while it is nice that Staff states that the APIF/Liberty Water shared
17 services model is "not inherently unreasonable";¹⁸ Staff's adjustment is unreasonable as it
18 ignores the benefits of the shared services model. These costs would simply not be
19 incurred by the parent company if the utilities and power generation facilities it owned did

20
21 ¹⁵ Tr. at 772:17 – 773:5. At the time of trial, Liberty Water did not have available a written
22 summary of its cost allocation methodology. However, in response to criticism by Staff in this
23 rate case, as well as in other pending rate cases, a written explanation has now been prepared
24 using the same information provide to Staff during the discovery phase of this rate case. This
document has been provided to the parties in the pending LPSCO rate case (and other pending
cases), where it will be offered into evidence. A copy is also attached hereto for illustrative
purposes as **Reply Brief Exhibit 1**.

25 ¹⁶ Staff Br. at 9:25-27.

26 ¹⁷ *Id.* at 7:9.

¹⁸ *Id.* at 9:24-25.

1 not exist.¹⁹ This model is applied as a whole, not in divisible parts, and the model's
2 obvious benefits are at risk if Staff's evisceration of the APIF cost allocation is adopted.

3 2. Known and Measurable Cost Increases

4 The Company proposed a roughly \$44,000 increase in the costs of service by
5 Liberty Water.²⁰ These increases were due to known and measurable personnel changes
6 and were necessary to reflect the costs of service during the period rates will be in effect.²¹
7 The cost increases result from the annualization of wages for Liberty Water employees
8 hired during the test year. Staff argues these costs should be disallowed because the
9 personnel costs are not directly attributable to BMSC.²² But that's the whole point of
10 Liberty Water's shared services model, a model Staff's witness testified Liberty Water
11 must use to be prudent.²³ Furthermore, this is a known and measurable increase in costs
12 Staff already found prudent and reasonable (with the exception of the issue of "bonuses").
13 In other words, the wages incurred during the test year were found to be reasonable. Staff
14 should not be heard to argue that the test year shared costs allocated from Liberty Water
15 are fine, but known and measurable changes to those costs are not allowed because they
16 are shared.

17 3. Performance Based Pay

18 The amounts Liberty Water pays its employees are certainly a part of Liberty
19 Water's cost of service, whether those amounts are paid as base salary or as incentive or
20 at-risk pay. As discussed above, Staff has not rejected any of the test year costs
21

22 ¹⁹ Tr. at 323:5-10.

23 ²⁰ Bourassa Rb. at 23:15-21; BMSC Final Sch. C-2, page 17. Staff has failed to update its records
24 to reflect the Company's position on this adjustment since rebuttal. Staff Br. at 15:16 (opposing
" \$50,302 " adjustment, the amount in direct that was changed by the rebuttal stage).

25 ²¹ Bourassa Rb. at 24:1-21.

26 ²² Staff Br. at 15:17-21.

²³ Tr. at 773:1-5, 775:8-15.

1 allocations to BMSC by Liberty Water, except these so-called “bonus” amounts. Staff’s
2 argument that these amounts are not “guaranteed to be paid” is a red-herring.²⁴ There is
3 no “guarantee” that any operating expense will be repeated the same as the test year once
4 new rates are approved. This is simply the nature of ratemaking, but the test year can and
5 should still be used to reflect the expected cost of service. Staff did not disagree with the
6 Company that the total compensation was excessive, just that since a portion of it was
7 performance based, that portion should be rejected.

8 **B. Rate Base Issues in Dispute in Dispute with Staff**

9 1. ADITs

10 Staff’s support for a \$200,000 deduction to rate base, in violation of SFAS 109 and
11 contrary to the Commission’s last rate order for BMSC, is that the Company never gave
12 Staff the document Staff needed to verify the ADIT calculation.²⁵ This isn’t true. BMSC
13 provided Staff the requested information within 48 hours of Staff’s request, with the
14 intervening day being the Thanksgiving Holiday.²⁶ That Staff did not receive this
15 information sooner is the result of Staff having never asked for it. Whatever the reason
16 for Staff’s failure, it would be entirely inequitable to penalize the Company.

17 This case was filed using a June 30, 2008 test year and promptly found sufficient
18 by Staff. Staff did not indicate it needed additional information on ADITs, even though
19 they were included in the Company’s initial filing.²⁷ Significant discovery was
20 conducted, yet Staff does not identify a single data request seeking year-end 2008 tax
21 information and a “roll-back” for the purposes of verifying the ADIT calculation. Staff
22 does not make any mention of ADITs anywhere in its direct filing. It was only when

23 _____
24 ²⁴ Staff Br. at 12:7-10.

25 ²⁵ *Id.* at 18:18-23.

26 ²⁶ Exs. A- 17 and A-18.

27 ²⁷ Bourassa Dt. at Sch. B-2, page 7.

1 Mr. Bourassa made conforming adjustments to ADITs because of rebuttal adjustments to
2 rate base that Staff even raised the issue of ADITs.²⁸ But Staff did not assert in surrebuttal
3 that it lacked information to verify the ADIT calculation; instead, Ms. Brown said that
4 something was amiss because the ADITS were positive, and that something was AIAC.²⁹
5 Ms. Brown retracted this claim at the hearing.³⁰ However, prior to that, the day after the
6 hearing started, Staff filed Ms. Brown's testimony claiming, for the first time 11 months
7 after the application was filed, that Staff lacked the information it needed to verify the
8 ADIT calculation.³¹ Then, at hearing, Ms. Brown explained that she presumed the
9 Company would have provided it;³² she never explained why she waited to complain
10 about the lack of this information until the day after the hearing began.

11 Staff's position on ADITs has been a moving target. Despite this, the Company
12 has given everything Staff has asked for, including the information Staff now claims it
13 needed but does not have. That information confirms that the Company's test year ADITs
14 of roughly \$195,000, which is determined by rolling forward from the 2007 tax return, is
15 actually conservative if reconciled to a 2008 tax year-end.³³ Put bluntly, BMSC has done
16 enough to try to help correct Staff's errors on this issue; despite this, Staff remains entirely
17 unable to offer a legitimate basis to reject the position advocated by RUCO and the
18

19
20 ²⁸ Bourassa Rb. at 8:1-8 and Sch. B-2, page 2; Bourassa Rj. at 6. Staff implies at the start of its
21 brief on this section that BMSC created the issue with Staff by making adjustments to its ADIT
22 calculation. Staff Br. at 18:4-6. The Company never changed its ADIT calculation methodology;
it merely adjusted the number by roughly \$25,000 because the ADITs change with rate base
adjustments. As Ms. Brown admitted, there was never anything wrong with the Company's
ADIT methodology. Tr. at 702:3-7, 739:21 – 740:13.

23 ²⁹ Brown Sb. at 8-9.

24 ³⁰ Tr. at 702:3-7, 739:21 – 740:13.

25 ³¹ Brown Supp. Sb. at 3:16-23.

26 ³² Tr. at 744:22 – 745:20.

³³ Ex. A-18 (showing positive ADITs of more than \$267,000).

1 Company. Staff's recommended disallowance of the ADIT is without any remaining
2 justification.

3 2. Working Capital

4 Staff correctly points out that BMSC is not seeking a working capital allowance,
5 despite the fact that the only lead-lag study submitted in this case shows a small, positive
6 working capital amount, an addition to rate base.³⁴ Staff is also correct that its witness
7 disputed several aspects of Mr. Bourassa's lead-lag study, although Staff discusses only
8 one of these disputes in its brief.³⁵ On that issue, the determination of the revenue lag,
9 Staff's basis is set forth in its brief, but its basis, like the testimony of its witness on this
10 issue, is inadequate. Mr. Bourassa measured the days from the 15th of the month (the
11 mid-point of the service period) to the customer payment date, based on actual customer
12 billing and payment data for a recent approximate 12-month period.³⁶ This was the same
13 way RUCO determined the revenue lag in the last rate case, and RUCO's position on
14 working capital was adopted in Decision No. 69164 because it was a "more accurate
15 representation of BMSC's actual cash working capital situation."³⁷ Using this method and
16 the data in this rate case, Mr. Bourassa measured a revenue lag of 12.78 days.³⁸

17 In its brief, Staff asserts that it recommends a revenue lag of 9.6 days.³⁹ But Staff's
18 Final Schedules reflect a recommended revenue lag of 8.88 days⁴⁰ even though no
19

20 ³⁴ Staff Br. at 17:6-8.

21 ³⁵ *Id.* at 17:18-20. Because Staff has not explained its reasons for disputing the Company's
22 position, except on the revenue lag, BMSC is unable to respond in this reply. The Company's
position on the other aspects of working capital in dispute is set forth in its initial closing brief.
BMSC Br. at 25-27.

23 ³⁶ Bourassa Rj. at 11:19 – 14:12.

24 ³⁷ *Id.* See also Decision No. 69164 at 7:18-20.

25 ³⁸ Bourassa Rj. at 14:11.

26 ³⁹ Staff Br. at 17:17.

⁴⁰ Staff Final Sch. CSB-10, page 2 of 3.

1 evidence was provided as to how Ms. Brown came up with this number. While the 8.88
2 revenue lag days is consistent with Ms. Brown's schedules filed after the hearing, a
3 revenue lag of 8.88 days is contrary to Ms. Brown's testimony that customers typically
4 pay 4 to 5 days before month-end.⁴¹ If the mid point of the service period is the 15th and
5 you add 8.88 days, you end up with the customer paying around the 24th of the month (15
6 plus 8.88 equals 23.88, then rounded). This is 6 to 7 days before the end of the month.⁴²
7 For this reason, among others, the zero working capital allowance recommended by
8 RUCO and BMSC should be adopted.

9 **C. Reply on Remaining Operating Expense Issues in Dispute with Staff**

10 **1. Transportation Expense**

11 As Staff correctly notes, the lease of BMSC's truck was signed by its affiliate,
12 Gold Canyon Sewer.⁴³ This is so because GCSC had an existing relationship with an auto
13 dealer that made the transaction more efficient.⁴⁴ Nevertheless, according to Staff, the
14 mere fact that the truck was leased in GCSC's name means that it could be shared with
15 another affiliate.⁴⁵ But the undisputed evidence in the record shows that operators
16 working for BMSC providing services to BMSC's customers use the truck solely for
17 BMSC.⁴⁶ Therefore, the Company has met its burden of proof, and this necessary and
18 reasonable operating expense needs to be recovered if BMSC is going to continue to incur
19 it.

20 ⁴¹ Brown Sb. at 12:12-16.

21 ⁴² Bourassa Rj. at 13:15-22.

22 ⁴³ Staff Br. at 12:17-18.

23 ⁴⁴ Sorensen Rb. at 15:15-17.

24 ⁴⁵ Tr. at 793:11-15. Staff's suggestion that mileage logs are "proper documentation" is a red-
25 herring. Staff Br. at 12:20. To begin with, when asked if transfer of the title would resolve
26 Staff's concerns, Ms. Brown said no because it would occur outside the test year, not that the
vehicle could still be shared. Tr. at 794:13-16. Moreover, mileage logs would have simply
showed what the evidence already shows, that this is BMSC's truck used solely by BMSC.

⁴⁶ Sorensen Rb. at 15:12 - 16:6; Sorensen Rj. at 15.

1 2. Testing Expense

2 Staff is correct in asserting that no contract or law currently obligates the Company
3 to conduct the additional testing “suggested” by the City of Scottsdale.⁴⁷ However, Staff
4 misses the point. The City has asked for this additional testing because the City has
5 already determined that it is in the public interest of health and safety to have one of its
6 large commercial customers, BMSC, conduct the testing.⁴⁸ BMSC hopes it will not have
7 to inform the City that it cannot perform the additional testing the City wants because the
8 Commission does not believe the costs are necessary in the public interest. This would be
9 particularly unfortunate given that BMSC is in the process of negotiating an extension of
10 its agreement with the City, as well as preparing to purchase the additional capacity
11 required for plant closure.

12 3. Rate Case Expense

13 Staff’s latest position on rate case expense is that the Company could not possibly
14 have incurred an additional \$50,000 of rate case expense due to the BHOA’s
15 intervention.⁴⁹ Of course, the Company ended up increasing its rate case expense request
16 by only \$40,000 from its original estimate, but Staff does not appear to have noticed. In
17 fact, Staff’s latest position comes after Ms. Brown first testified that she agreed that the
18 amount of rate case expense should be increased due to the BHOA’s intervention, but that
19 she still needed to verify the costs and would do so before the hearing.⁵⁰ Then, after the
20 trial started, Ms. Brown changed her mind and argued that no additional rate case expense

21 _____
22 ⁴⁷ Staff Br. at 11:3-21.

23 ⁴⁸ Sorensen Rj. at 12:4-10.

24 ⁴⁹ Staff Br. at 13:11-20. This argument should not be heard from Staff in the briefing in the first
25 place. Staff did not take this position on this expense prior to filing its post-hearing brief, nor did
26 it have any of its witnesses claim that the amount of the Company’s rate case expense was not
reasonable. It is fundamental to rate case due process that the utility be presented with the basis
for Staff’s adjustments before trial, not after in the post-hearing briefing.

⁵⁰ Brown Sb. at 23:17 – 24:6.

1 should be allowed because the BHOA issue was “not pertinent” to the rate case.⁵¹ The
2 determination that the issue was “not pertinent” is interesting considering how much of
3 the hearing time was spent by all parties discussing this issue, including almost the
4 entirety of the public comment.

5 Now, Staff concedes that the BHOA’s intervention is relevant to this rate
6 proceeding but claims that “it is inconceivable” that BMSC incurred all the expenses after
7 the rate case started.⁵² Perhaps Staff should have had its witness actually review the
8 supporting documentation for the additional rate case expense before alleging that the
9 Company is seeking to improperly recover expenses as rate case expense. But Ms. Brown
10 declined to review that verification when she changed her mind and declared the BHOA’s
11 intervention to be immaterial to this rate case.⁵³ The evidence shows that the only
12 amounts sought for recovery through rate case expense are the amounts incurred in this
13 rate case.⁵⁴ Again, Staff could have verified this evidence, but chose not to do so. As
14 such, Staff has no basis and can offer no evidence to support its latest claim that the
15 amount of rate case expense incurred after the BHOA intervened is unreasonable.

16 **D. Reply on Operating Expense Issues in Dispute with RUCO**

17 The discussion of resolved issues at the beginning of RUCO’s brief reflects the
18 success of the cooperative efforts between Mr. Moore and Mr. Bourassa, and the
19 Company commends Mr. Moore for his efforts to resolve issues in dispute.⁵⁵ Through
20 these efforts, the expenditure of the parties’ resources, including rate case expense, was
21 reduced, which also reduces the necessary burden on Commission resources. At this time,
22

23 ⁵¹ Brown Supp. Sb. at 6:8-15.

24 ⁵² Staff Br. at 13:9-11, 13:14-17.

25 ⁵³ Tr. at 795:11-15.

26 ⁵⁴ Tr. at 218:1-8, 365:11-15.

⁵⁵ RUCO Br. at 1-4.

1 there are only 3 income statement issues in dispute between BMSC and RUCO, one of
2 which is new to the proceedings. These issues are discussed below.

3 1. Non-Recurring Expenses

4 RUCO recommends two adjustments to operating expenses to account for what
5 RUCO claims are non-recurring costs. The first includes \$1,500 of legal and survey costs
6 related to an easement dispute.⁵⁶ The second includes costs for a spill remediation that
7 resulted in avoidance of any fines or penalties from the State and County. As to the legal
8 and survey costs, RUCO's assertion that this was a one-time dispute misses the point.
9 This time BMSC incurred legal and survey costs for this easement dispute. Next time, it
10 will be a different easement dispute or some other problem. But legal and survey costs
11 are a normal and typical operating expense, a fact that RUCO's recommendation ignores.
12 Likewise, the Company operates a wastewater collection, transmission and treatment
13 system. The cost of cleaning up these discharges of waste product is a cost of doing
14 business;⁵⁷ and the recommended normalization proposed by Staff is fair and reasonable
15 to reflect the average level of expense to be incurred on average annually during the
16 period rates will be in effect.⁵⁸ The Company also agrees with the normalization of legal
17 and engineering expenses; however, Staff's normalization adjustment contains an error by
18 double counting \$1,500 of expense.⁵⁹

19 2. Bad Debt Expense

20 RUCO continues to ignore amounts billed during the test year but written off
21 after.⁶⁰ These amounts are known and measurable, and there is no dispute that the bad
22

23 ⁵⁶ RUCO Br. at 4:18-22.

24 ⁵⁷ Sorensen Rj. at 6:1-15.

25 ⁵⁸ Staff Final Sch. CSB-20.

26 ⁵⁹ Bourassa Rb. at 14-15; Bourassa Rj. at 29.

⁶⁰ RUCO Br. at 5.

1 debt arose as a result of unpaid test year bills for test year utility services.⁶¹ In that light,
2 RUCO's continued assertion that it believes its position is reasonable is inadequate to
3 support its recommended adjustment.

4 3. Rate Case Expense

5 Finally, after all the prefiled testimony, after 4 days of hearings, after the filing of
6 Final Schedules, RUCO has decided to take a position on rate case expense. According to
7 RUCO, the Company should only recover \$180,000 because expenses related to the
8 BHOA's intervention are the result of a "one-time event unrelated to normal rate case
9 proceedings."⁶² This argument appears to be a reincarnation of Staff's supplemental
10 surrebuttal position that the BHOA issue was irrelevant, a position Staff has now recanted
11 in its brief.⁶³ RUCO does not explain what "normal" is, nor does RUCO explain what the
12 Company was supposed to have done to avoid incurring extra rate case expense once the
13 BHOA was granted intervention and its claim for relief dominated the proceedings.
14 RUCO's argument that this is a unique event also undermines its own witness' steadfast
15 refusal to agree that the matter was unique.⁶⁴ In any event, RUCO does not explain why
16 the Company should bear the burden of rate case expense to address an issue raised by its
17 ratepayers just because the event is unique. Nor should BMSC have to explain it again as
18 it has already more than adequately supported as reasonable its request for recovery of
19 \$220,000 of rate case expense amortized over 3 years.

20 **III. REPLY TO RUCO ON COST OF CAPITAL**

21 Staff does not address cost of capital in its closing brief, therefore, the Company
22 hereby incorporates its response to Staff's cost of capital recommendations from its

23 _____
24 ⁶¹ Bourassa Rb. at 16:1-14; Brown Supp. Sb. at 5:21 – 6:6.

25 ⁶² RUCO Br. at 5:17-6:5.

26 ⁶³ Staff Br. at 13:9-11.

⁶⁴ Tr. at 521:11-21, 529:7 – 532:1.

1 closing brief.⁶⁵ RUCO, on the other hand, spends more than half its brief on cost of
2 capital, most of that arguing for its recommended hypothetical capital structure.⁶⁶ RUCO
3 begins this argument by attempting to cast Staff witness Juan Manrique as a witness in
4 favor of RUCO's recommended hypothetical capital structure.⁶⁷ However,
5 Mr. Manrique's acknowledgement that a hypothetical capital structure is another means of
6 accounting for financial risk is hardly a ringing endorsement of RUCO's recommendation.
7 Surely, had Staff felt that a hypothetical capital structure was warranted, Mr. Manrique
8 would have recommended one. In fact, Mr. Manrique was following Staff's
9 methodologies as he has learned them since coming to work at the Commission,⁶⁸ and
10 Staff believes the Hamada methodology is more appropriate because it is based on
11 financial theory.⁶⁹ In contrast, RUCO's capital structure is based on conjecture.

12 That RUCO's recommended hypothetical capital structure is also "results oriented"
13 is not BMSC's "assertion" as RUCO alleges;⁷⁰ it is the express finding of the Commission
14 for BMSC under virtually identical circumstances in the last rate case decided just three
15 years ago.⁷¹ The Commission was right, RUCO's recommendation is "results oriented."
16 More than a decade ago, the Commission decided to ignore the debt in BMSC's capital
17 structure, over the objection of the Company and RUCO.⁷² Now, RUCO seeks to use the
18 Commission's failure to consider BMSC's debt for ratemaking as a springboard to
19 artificially reduce BMSC's revenue requirement. BMSC has nearly the same amount of

20 ⁶⁵ See, generally, BMSC Br. at 30-35.

21 ⁶⁶ RUCO Br. at 6-16.

22 ⁶⁷ *Id.* at 6-7 citing Tr. at 682:12-15.

23 ⁶⁸ Tr. at 684:12-21.

24 ⁶⁹ See Transcript from March 31, 2008 hearing at 445-446, *Gold Canyon Sewer Company*, Docket
25 No. SW-02519A-06-0015.

26 ⁷⁰ RUCO Br. at 7:3-4.

⁷¹ Decision No. 69164 at 20:14-17.

⁷² Decision No. 59944 (December 26, 1996) at 3-6.

1 debt in its actual capital structure as its affiliate, LPSCO. Yet, Mr. Rigsby does not argue
2 for a hypothetical capital structure in that pending rate case.⁷³ Indeed, RUCO makes a
3 point of the fact that it recommends a hypothetical capital structure because of the
4 fictitious income tax deduction, an adjustment that significantly lowers the Company's
5 revenue requirement by reducing operating expenses.⁷⁴ The resulting lower revenue is
6 exactly what RUCO is after, which is why the Commission has already rejected RUCO's
7 recommendation once before because it was "results oriented". The Commission should
8 do so again. It would be inequitable to penalize BMSC for not having debt in its capital
9 structure for rate making simply because a past Commission decided to ignore the debt.

10 The Commission should also reject RUCO's recommended return on equity. The
11 Company has already explained its opposition to the use of gas companies in its closing
12 brief and will not reiterate those arguments.⁷⁵ The Company also reiterates its opposition
13 to the use of the geometric mean risk premium in the CAPM.⁷⁶ The geometric mean
14 should not be used to determine prospective returns.⁷⁷ In short, while geometric averages
15 provide a useful way to compare past performance of assets (which is why they are widely
16 reported), they fail to capture future volatility (i.e., risk) and, as a result, understate the
17 required return on an investment in a risky asset. RUCO asserts that the use of a
18 geometric mean is the industry standard.⁷⁸ Mr. Rigsby asserted that Morningstar, in its
19 annual valuation yearbook, reports both arithmetic and geometric mean returns, and that
20

21 ⁷³ See Direct Testimony of William A. Rigsby (November 4, 2009), Docket Nos. SW-01428A-
22 09-0103, W-01427A-09-0104, SW-01427A-09-0116, and W-01427A-09-0120, at 55 and Sch.
WAR-1, page 1 of 3.

23 ⁷⁴ RUCO Br. at 9:8-12.

24 ⁷⁵ BMSC Br. at 32:18 – 33:10.

25 ⁷⁶ *Id.* at 33:11-34:4.

26 ⁷⁷ *Id.*

⁷⁸ RUCO Br. at 13.

1 investors would therefore rely on both.⁷⁹ But Morningstar states that “[t]he equity risk
2 premium data presented in this book are arithmetic average risk premia as opposed to
3 geometric average risk premia,” and further explains why future returns should be
4 estimated with arithmetic averages, not geometric averages.⁸⁰ Rather than focusing on
5 what method is conceptually correct, RUCO contends that if an investor has information
6 available, such information should be used to determine the Company’s cost of equity
7 even if its use is improper.

8 Perhaps most importantly, RUCO’s assertion that its 8.22 percent return on equity
9 “is not too low” is belied by the evidence. Mr. Rigsby testified that under the standards
10 set forth by the “landmark” Supreme Court decisions in *Bluefield* and *Hope*, the cost of
11 capital must be sufficient to instill confidence in the utility’s financial integrity and to
12 attract capital.⁸¹ Yet, the undisputed evidence in the record before the Commission is that
13 RUCO’s 8.22 percent return on equity, even without the hypothetical capital structure, “is
14 too low.” APIF, the source of capital, has a large number of investment opportunities,
15 including investments in water and sewer utilities in other states where it can realize
16 higher returns faster.⁸² It is simple economics that investment capital will not flow to a
17 lower return when there are other better investment options available. Indeed, APIF has
18 an obligation to its investors to minimize investment in high risk, low return investments.
19 In other words, RUCO’s 8.22 percent return on equity is too low, unless the goal is for
20 BMSC to only attract the bare minimum amount of capital it needs to maintain the bare
21 minimum level of service.⁸³

22
23 ⁷⁹ Rigsby Sb. at 23-25; RUCO Br. at 13.

24 ⁸⁰ *Ibbotson SBBI 2009 Valuation Yearbook* (Morningstar) at 59.

25 ⁸¹ Rigsby Dt. at 8:9-23.

26 ⁸² Sorensen Rb. at 10:8 – 11:17.

⁸³ Tr. at 197:21-25.

1 **IV. REPLY ON RATE DESIGN ISSUES**

2 **A. Special Rate Customers**

3 “Staff’s position is that the special rates classes currently incorporated into
4 BMSC’s tariff should remain in place.”⁸⁴ Staff does not say why, does not offer or rely
5 upon any evidence to supports its position, and does not rebut the evidence offered by the
6 Company.⁸⁵ As a result, Staff is now asserting that the Commission should retain special
7 rates for several customers that no longer obtain service from the Company, along with a
8 few rates for customers that are entirely unexplained. Absent a basis to retain the existing
9 “special rates,” they should be eliminated.

10 **B. Hook Up Fee Tariff**

11 Staff recommends denial of any hook up fee tariff because BMSC already has
12 enough wastewater treatment capacity.⁸⁶ But funds paid under a hook up fee tariff can be
13 used by the utility to fund a variety of off-site plant including sludge disposal facilities,
14 effluent disposal facilities, lift stations and transportation mains, in addition to treatment
15 capacity.⁸⁷ Thus, a hook up fee tariff provides a source of zero cost capital to be used to
16 build backbone plant consistent with this Commission’s often-espoused growth pays for
17 growth philosophy.⁸⁸

18 Furthermore, it isn’t clear when BMSC will need additional capacity. The
19 Company currently has a treatment facility capable of treating 120,000 gpd and it has the
20 right to send up to 400,000 gallons of capacity per day to the City of Scottsdale.⁸⁹

21 _____
22 ⁸⁴ Staff Br. at 15:11-12. Staff and the Company appear in agreement that Engineering Bulletin
No. 12 does not work for a modern low flow dental office like Dr. Doelle’s. *Id.* at 15:12-14.

23 ⁸⁵ Bourassa Dt. at 16-18; Sorensen Rb. at 4:3-8.

24 ⁸⁶ Staff Br. at 10:17-19.

25 ⁸⁷ *E.g.*, Hains Sb. at Exhibit 1; Sorensen Rj. at Sorensen Rejoinder Exhibit 1.

26 ⁸⁸ Sorensen Dt. at 13:12-13.

⁸⁹ Tr. at 104:3-6.

1 Assuming the plant closure, the Company will have the right to send 520,000 gpd to the
2 City for treatment. During the test year, the Company's peak flows were over
3 500,000 gpd per day, which is more than 95% of the Company's available treatment
4 capacity.⁹⁰ We may not know exactly when BMSC will need more capacity, and in what
5 increments, but it is clear that it will need more capacity. A HUF tariff simply provides
6 one of the funding mechanisms for needed additional capacity.

7 Finally, Staff suggests a HUF amount in the event the Commission decides a hook-
8 up fee tariff is appropriate.⁹¹ The Company has already incorporated Staff's
9 recommended HUF amounts into its requested HUF tariff, which form was recommended
10 by Staff in the pending LPSCO rate case.⁹² Now it should be approved.

11 **C. The Town's Request for Additional Refunds**

12 The Town correctly points out that no party objects to BMSC's proposed refunds
13 to the individual members of the CIE Homeowners' Association and related debits to
14 customers who received the full refund amount ordered by the Commission in Decision
15 No. 69164.⁹³ While the Company also agrees with the Town that the additional refunds
16 and debits do not constitute retroactive ratemaking,⁹⁴ the Company does not necessarily
17 agree with the Town's characterization of the ratemaking process in Arizona as
18 "legislative".⁹⁵ In fact, the ratemaking process in Arizona has been described as quasi-
19 judicial in nature and it is well established that Commission rate decisions shall be based
20 on the evidence in the record before the Commission, and only that evidence.⁹⁶ Despite

21 _____
22 ⁹⁰ Hains Dt. at Engineering Report, pages 4-5.

23 ⁹¹ Staff Br. at 10:20 – 11:2.

24 ⁹² BMSC Br. at Brief Exhibit 2.

25 ⁹³ See Town Br. at 3:27 – 4:1.

26 ⁹⁴ See BMSC Br. at 35-36.

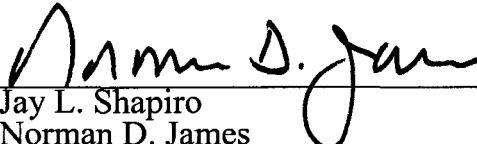
⁹⁵ See Town Br. at 4-6.

⁹⁶ *State ex rel. Corbin v. Arizona Corp. Com'n*, 143 Ariz. 219, 693 P.2d 362 (App. 1984).

1 this difference of opinion, BMSC and the Town agree on two things: the amount of the
2 additional refunds and associated debits; and that the relief requested is not unlawful.

3 RESPECTFULLY SUBMITTED this 22nd day of December, 2009.

4 FENNEMORE CRAIG, P.C.

5
6 By 
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12 **ORIGINAL** and thirteen (13) copies
13 of the foregoing were filed
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16 Arizona Corporation Commission
17 1200 W. Washington Street
18 Phoenix, AZ 85007

19 **Copy of the foregoing was hand delivered**
20 this 22nd day of December, 2009, with:

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Black Mountain Sewer Corporation
Docket No. SW-02361A-08-0609

REPLY CLOSING BRIEF
December 22, 2009

Brief Exhibit 1

**LIBERTY WATER AFFILIATE
COST ALLOCATION METHODOLOGY**

**LIBERTY WATER AFFILIATE COST ALLOCATION
METHODOLOGY**

I. GENERAL STATEMENT OF ALLOCATION METHODOLOGY

The purpose of this paper is to provide a detailed explanation of the Affiliate Cost Allocation Methodology used by the regulated utility affiliates of Liberty Water Company ("LWC") including Litchfield Park Service Company ("LPSCO"), Black Mountain Sewer Company, Gold Canyon Sewer Company, Rio Rico Utilities, Bella Vista Water Company, Northern Sunrise Water Company, and Southern Sunrise Water Company (collectively the "Regulated Utilities"). The Regulated Utilities are wholly-owned subsidiaries of LWC, which is owned by Algonquin Power Income Fund ("APIF").

A. The APIF Corporate Structure.

APIF's primary business is ownership of generating and infrastructure facilities through investments in securities of subsidiaries. APIF owns a widely diversified portfolio of 46 electric facilities and 17 water distribution and wastewater treatment facilities in Canada and the United States. APIF also has an operating interest in eight other facilities, but does not own them. APIF is publicly traded on the Toronto Stock Exchange. APIF's structure as a publicly traded income fund provides substantial benefits to its Regulated Utilities through access to capital markets and access to engineers, technicians, professional managers and administrative staff, including trained plant operators and field supervisors.

B. Liberty Water Cost Allocations to LPSCO.

LPSCO and the other Regulated Utilities in Arizona do not operate as stand-alone utilities. LPSCO is operated by Algonquin Water Services d/b/a Liberty Water ("Liberty Water"), along with six other regulated Arizona water and sewer utilities, and eleven regulated water and sewer providers located in Texas, Missouri and Illinois. Liberty Water provides all of the day-to-day administration and operations personnel for these regulated utilities. All operations and engineering labor is charged by Liberty Water directly to LPSCO and the other separate Regulated Utilities operated by Liberty Water. Liberty Water charges those labor rates at cost, which is the dollar hourly rate per employee as recorded in Liberty Water's payroll system, grossed up by 35% for burdens such as payroll taxes, health benefits, retirement plans, and other insurance provided to employees. Engineering technical labor, which is capitalized, is charged on the same basis, plus an allocation of 10% for Liberty Water's corporate overheads such as rent, materials/supplies, etc.

LIBERTY WATER AFFILIATE COST ALLOCATION METHODOLOGY

Other necessary services provided by Liberty Water for the Regulated Utilities cannot be directly charged to LPSCO and the other Regulated Utilities. Labor for accounting, billing and customer service, human resources, health and safety, and corporate finance cannot be directly allocated using timesheets due to the nature of the costs because it is not practical to keep track of time for employees that serve multiple utilities in small time increments during the course of a work-day. A shared call center is the perfect example. A customer service representative at Liberty Water's call center will field calls from customers of LPSCO, BMSC, Bella Vista Water Company in southern Arizona and the three other states. This work directly benefits all of the Regulated Utilities, so the costs need to be allocated to all of them. These costs are allocated based on the relative customer counts of all of the Regulated Utilities. Using customer counts allows Liberty Water to allocate those costs to an individual utility, such as LPSCO, based on the relative burden of that utility relating to those services.

Overhead costs, like rent, insurance, administration costs, depreciation of office furniture and computers, also cannot be directly attributed to specific utilities. These costs are allocated to LPSCO and its affiliates by use of a "four factor" methodology that considers relative size through four weighted factors – total plant, total customers, expenses and labor. This type of four-factor methodology has been utilized by other Arizona utilities, including Chaparral City Water Company and Global Water. All of the costs charged by Liberty Water and allocated to LPSCO are based on actual costs, either directly charged or through the allocations described above.

B. Central Office Cost Allocations from Algonquin Power Trust.

In addition to the operations and engineering direct costs, and the allocated overhead/administration costs charged by Liberty Water, LPSCO and the other utilities in this shared services model benefit from costs incurred by the Algonquin corporate parent. Specifically, APIF, the shareholder of Liberty Water, allocates a share of the costs incurred by its operating arm Algonquin Power Trust ("APT") in providing necessary and required services to the Regulated Utilities.

APT is the affiliate that provides financial, strategic management, compliance, administrative and support services to the Regulated Utilities operated by Liberty Water, as well as to the numerous unregulated utility assets owned by the corporate parent, APIF. APT does not have any staff and the costs incurred by it are non-labor based. The head office of APT is located in Oakville, Ontario, Canada and provides administrative, technical and management support, regulatory compliance, and oversight of strategic direction, including approvals of

LIBERTY WATER AFFILIATE COST ALLOCATION METHODOLOGY

budgets and ensuring a strict level of corporate governance for LPSCO and all of the utilities operated by Liberty Water. APT's executive management and administrative support includes accounting and finance, human resources, employee benefits, regulatory and information systems services.

The services provided by APT are necessary to allow LPSCO and the other Regulated Utilities to have access to capital markets for capital projects and operations, and are necessary to allow LPSCO to provide a high level of service at the lowest cost. There are no direct labor costs included in the corporate administration Central Office Cost allocation from APT. Instead, these costs include professional services like third-party legal services, accounting services, tax planning and filings, and required auditing that are done for the benefit of all of the Liberty Water Regulated Utilities, including LPSCO.

These corporate headquarter administrative costs also include costs for licenses, fees and permits, information technology/systems, payroll, and HRIS maintenance contracts, as well as the rent and depreciation of office furniture and equipment and computers in the central office in Oakville, Ontario. Fees for these services are allocated to the Regulated Utilities using generally accepted allocation principles. These services are routine and recurring in nature and performed on a regular basis as part of normal business operations for Liberty Water and its Regulated Utilities.

These administration Central Office Costs are allocated to LPSCO in two phases. The first phase involves allocating these costs to each of the facilities, both regulated and unregulated, owned by APIF. That initial allocation is made based on relative size. Specifically, APIF owns and operates 63 total entities, 17 of which are the Regulated Utilities operated by Liberty Water. In turn, 17 of 63 is 26.98%, which means 26.98 percent of the total Central Office Costs are allocated to the Regulated Utilities operated by Liberty Water.¹

From there, the second allocation phase is that Liberty Water allocates the Central Office Costs between LPSCO and the 16 other Regulated Utilities based on customer counts. These costs are incurred for the benefit of all of the Regulated Utilities and their customers, but are not capable of being directly charged to the 63 separate operating assets. This cost allocation methodology ensures that the costs are allocated as closely as possible to the originator of those

¹ For illustrative purposes, if the total Central Office Costs incurred by APT was \$4,000,000, then \$1,079,200 ($4,000,000 \times .2698$) in Central Office Costs would be allocated to the 17 Regulated Utilities under Liberty Water. The remaining \$2,920,800 (73.02%) in Central Office Costs would be allocated to the remaining 46 electric facilities owned by APIF.

LIBERTY WATER AFFILIATE COST ALLOCATION METHODOLOGY

costs. An entity such as LPSCO with 33,000 water and sewer customers benefits more from these costs than BMSC with only 2,000 wastewater ratepayers. Specifically, LPSCO has 16,037 water customers and 17,068 wastewater customers, for a total of 33,105 customers. In total, Liberty Water's 17 Regulated Utilities have 68,783 water and wastewater customers, which means LPSCO is allocated 48.13% ($33,105/68,783$) of the Central Office Cost pool.

The fundamental principle of this Cost Allocation Methodology is that LPSCO and the other Regulated Utilities should be charged for all costs incurred by affiliates—both Liberty Water and APT—so that the Regulated Utilities can provide a high level of safe and reliable water and wastewater utility service to customers.

II. DETAILED EXPLANATION OF THE SERVICES PROVIDED AND COSTS ALLOCATED TO THE REGULATED UTILITIES.

The following is a detailed description of how these cost allocation methodologies are applied to the Regulated Utilities, the benefits of the services provided by Liberty Water and APT, the need for such services in the provision of utility services and the necessity of allocating costs to the Regulated Utilities.

A. Liberty Water Services Provided to LPSCO.

Attached as Appendix 1 is an allocation summary of how costs incurred by Liberty Water are allocated to the Regulated Utilities, including LPSCO. Whenever possible, costs incurred by Liberty Water for a particular Regulated Utility are directly charged to that utility based on time sheets.

1. Operations and Engineering Labor.

These costs are billed directly to the Regulated Utility that required the labor, as documented by time sheets. Attached as Appendix 2 is an example time sheet used by Liberty Water. Those direct charges are principally direct labor, including operations and engineering. For example, the costs for a plant operator working solely for LPSCO will be directly allocated to LPSCO without any further allocation necessary. Liberty Water direct charges those services to the Regulated Utilities at cost. The labor rate charged by Liberty Water is the dollar hourly rate per employee as recorded in Liberty Water's payroll system, grossed up by roughly 35% for burdens such as payroll taxes, health benefits, retirement

LIBERTY WATER AFFILIATE COST ALLOCATION METHODOLOGY

plans, and other insurance provided to employees.² Engineering technical labor, which is capitalized, is charged on the same basis, plus a 10% allocation for corporate overheads incurred by Liberty Water, including rent, materials, supplies and other similar overhead costs.

2. Accounting, Billing and Customer Service Labor Costs.

Liberty Water also incurs additional labor costs for accounting, billing, and customer service, human resources, health and safety, and corporate finance, which are necessary for the Regulated Utilities to provide adequate and reliable water and wastewater service to customers. Those costs, however, cannot be allocated to each Regulated Utility using time sheets due to the nature of the costs. It is not practical to keep track of time for employees that serve multiple utilities during the course of a work day. For example, an accounting analyst may analyze the financial performance of all Regulated Utilities at the same time. Her accounting work benefits all such Regulated Utilities, so her services and costs would be allocated to all Regulated Utilities. Likewise, a customer service representative at Liberty Water's call center will field calls from customers of all Regulated Utilities during a work day. Again, his work directly benefits all such Utilities and his costs should be allocated to all Regulated Utilities.

These labor costs incurred by Liberty Water are allocated to the Regulated Utilities based on customer count. The following simplified example demonstrates how a customer service representative's costs would be allocated to LPSCO:

Annual Salary	\$30,000
Burden (at 35%)	\$10,500
Total Labor Cost	\$40,500

Total Liberty Water Customers: 68,783

LPSCO Water Customers: 16,037 (23.32% of total customers)

LPSCO Wastewater Customers: 17,068 (24.81% of total customers)

² It bears emphasis that the Liberty Water allocations reflect actual costs incurred. Liberty Water now charges based on actual payroll rates, not market based rates. Liberty Water made that change in early 2008, which means that rate cases pending before that change was made have been trued up and adjusted to reflect this actual cost methodology as if it had been adopted at the beginning of the respective test year.

**LIBERTY WATER AFFILIATE
COST ALLOCATION METHODOLOGY**

Salary Costs allocated to LPSCO Water: \$9,444.60 (40,500 x .2332)

Salary Costs allocated to LPSCO Wastewater \$10,049.78 (40,500 x .2481)

Salary Costs allocated to all other Regulated Utilities: \$21,005.62

3. Liberty Water Overhead Costs.

Costs incurred by Liberty Water for rent, administrative costs, depreciation of office furniture, depreciation of computers, and other labor cannot be directly attributed to a specific Regulated Utility. As such, those overhead and administrative Costs are allocated to the Regulated Utilities by use of the "four factor" methodology. Other costs in this category include insurance, janitorial services and other general non-payroll costs.

The "four factor" methodology allocates costs by relative size of the utilities. The methodology used by Liberty Water involves (1) Rate Base, (2) Total Customers, (3) Non-Labor Expenses and (3) Labor as allocating factors, with each factor assigned a specific weight. Liberty Water uses the following weights under this four factor methodology:

UTILITY PLANT	50%
CUSTOMER COUNT	40%
LABOR	5%
EXPENSES	5%
TOTAL	100%

The following simplified hypothetical example demonstrates how the four factor allocation methodology would be calculated based on ownership of *only* two hypothetical utilities (LPSCO and BMSC):

FACTOR	LPSCO	BMSC	TOTAL ALL UTILITIES	LPSCO % OF TOTAL	FACTOR WEIGHT	LPSCO ALLOCATION
UTILITY PLANT	727	371	1098	66%	50%	33%
CUSTOMER COUNT	6000	1000	7000	86%	40%	34%
LABOR COSTS	57	32	89	64%	5%	3%
EXPENSES	108	41	149	72%	5%	4%
TOTAL ALLOCATION TO LPSCO						74%

LIBERTY WATER AFFILIATE COST ALLOCATION METHODOLOGY

As can be seen from these hypothetical numbers, LPSCO would be allocated 74% of total Administrative/Overhead Costs incurred by Liberty Water, based on its relative size and application of the four factors in comparison to BMSC. BMSC would be allocated the remaining 26%. Liberty Water developed and utilized this methodology, including all 17 of its utilities, to better allocate costs, recognizing that larger utilities require more time and management attention and incur greater costs than smaller ones.

4. Customer Benefits of Liberty Water Allocation Model.

Customers of Liberty Water receive significant benefits from this cost allocation model, including significantly lower costs incurred by the Regulated Utilities for services that are essential and necessary to the provision of high quality water and wastewater utility service. The benefits of this type of shared service model include:

- Savings on labor costs by resource sharing – since most Liberty Water employees are not dedicated to a specific utility, the utilities do not need to hire their own dedicated staff, thus resulting in significant cost savings.
- Four factor allocations allow for utilities to be charged by relative resources and management attention required to operate them. This means customers of smaller utilities do not subsidize costs of larger utilities. Essentially, this allocation methodology allows costs to be allocated based on the relative burdens and costs incurred by individual utilities.
- Because it's scalable, the shared services model allows for increased growth with less than proportional cost increases, meaning the Regulated Utilities can grow without incurring a proportionate or prohibitive increase in the cost of service.

B. APT Services Provided to LPSCO.

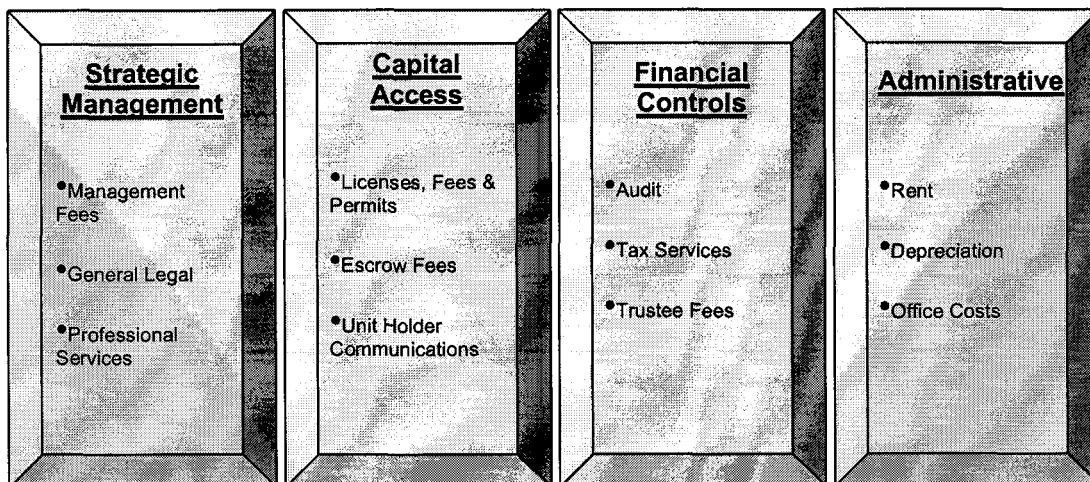
Attached as Appendix 3 is an overview of the services and allocations for APT. As noted above, APT is a wholly-owned subsidiary of APIF. APT is integral to APIF's business structure as a publicly traded income fund on the Toronto Stock Exchange. APIF sells units to public investors in order to generate the funding and capital necessary for the Regulated Utilities to provide utility service. APT provides all of the administrative services for APIF and all of APIF's facilities, including strategic management services, access to capital markets, corporate governance, and administration and management of the Regulated Utilities.

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The capital and funds obtained from the sale of units in the Income Fund are used by the Regulated Utilities for capital investments. That capital is made available by APT to the Regulated Utilities. The services provided by APT are critical and necessary to the Regulated Utilities because without those services the Regulated Utilities would not have a readily available source of capital funding. Put another way, absent the services provided by APT, the Regulated Utilities would be forced to operate as stand-alone utilities, with resulting higher costs and operating expenses incurred by customers. In addition, the utilities would bare much greater risk due to a potential inability to obtain capital on a stand-alone basis.

The services provided by APT optimize performance of the Regulated Utilities, keeping rates low for customers while ensuring access to capital is available. If the Regulated Utilities did not have access to the services provided by APT, then the Regulated Utilities would be forced to incur associated costs for financing, capital investment, audits, taxes and other similar services on a stand-alone basis, which would substantially increase such costs for each Regulated Utility. It bears emphasis that if the costs incurred by APT are not allocated to LPSCO and the other Regulated Utilities, then APT and APIF will have no choice but to cease providing the capital funding and other services to LPSCO and the other Arizona Regulated Utilities.

The services provided by and the costs incurred by APT for the Regulated Utilities fall into four general categories:



All of these costs incurred by APT are calculated and totaled into the administration Central Office Cost Pool. As noted above, that administration Central Office Cost Pool is then allocated to APIF's electrical facilities and

LIBERTY WATER AFFILIATE COST ALLOCATION METHODOLOGY

water/wastewater facilities based on the number of entities involved. In total, APIF owns 46 electric facilities and 17 water/wastewater utilities. Thus, the Central Office Cost Pools is allocated based on facility count with 73.02% (46/63) of the Pool allocated to the electric facilities and 26.98% (17/63) of the Pool allocated to the Regulated Utilities. For example, if the total administration Central Office Cost Pool incurred by APT is \$4,000,000, then \$1,079,200 ($4,000,000 \times .2698$) in administration Central Office Costs would be allocated to the 17 Regulated Utilities under Liberty Water. The remaining \$2,920,800 (73.02%) in administration Central Offices costs would be allocated to the remaining 46 electric facilities owned by APIF.

The allocated administration Central Office Cost Pool for the Regulated Utilities then is allocated to each individual utility by customer count. As noted in attached Appendix 3, LPSCO would be allocated 49% of those costs based on customer count. In our hypothetical example, LPSCO would be allocated \$518,016 in costs from APT. The following is a detailed description of each cost component within the Central Office Cost Pool, the necessity of allocating such costs to Regulated Utilities in providing services and the associated benefits to ratepayers.

1. APT Strategic Management Costs

Strategic management decisions are critical for any public utility. The need for strategic management is even more pronounced for APIF as a publicly traded income fund, which depends on access to capital funding through public sales of units in the fund. APIF seeks to hire talented strategic managers that aid in running each facility owned by the fund as efficiently and effectively as possible. This ensures the long term health of each utility and ensures that rates are kept as low as possible without compromising the level of service. It also facilitates each Regulated Utility's access to necessary capital funding at reduced costs. The costs included in Strategic Management Costs fall into the following categories.

MANAGEMENT FEES

Description	Fees which incorporate salaries of senior management staff for strategic management of all APIF facilities. The executives at APT provide the financial and capital funding services necessary for the Regulated Utilities to fund utility operations and growth services.
Allocation Method	Management Fees are charged by APT as a monthly fee which is allocated to the utilities division (26.98%), and then to each individual utility based on customer count.

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Ratepayer Benefits	Rate payers avoid the burdens of senior management staff at each utility by sharing of resources between all utilities, resulting in significant savings. These management services also allow Regulated Utilities to have an available source of capital funding for plant and infrastructure in the provision of utility services at a cost cheaper than what such utilities could obtain on their own.
Need for Management Services	APT management services are required in the provision of service by Regulated Utilities because the APT managers oversee utility operations, provide high level approvals for capital and operating budgets, and provide strategic planning services for the utilities. They also develop overall corporate strategies, negotiate contracts, allocate capital among utilities and approve high level expenditures. These management services are required in order for APIF to provide capital funding to individual utilities, without which the utilities could not provide adequate service.

GENERAL LEGAL SERVICES

Description	Legal expenses incurred by APT for general legal matters pertaining to all facilities owned by APIF. These legal services are required in order for APIF to provide capital funding to individual utilities, without which the utilities could not provide adequate service.
Services Provided	These legal services involve legal matters not specific to any single facility, including review of audited financial statements, annual information filings, Sedar filings, review of contracts with credit facilities, incorporation, tax issues of a legal nature, market compliance, and other similar legal costs.
Ratepayer Benefits	General legal costs help ensure that the APIF and the Regulated Utilities remain compliant in all aspects of operations and prevent those entities from being exposed to unnecessary risks. These legal services also allow utilities to have continued access to capital markets available to APIF.
Need for Legal Services	These legal expenses are critical to utility operations because they ensure APIF's status and viability as a publicly traded income fund and allow the utilities to provide service in a way to ensure continued access to strategic management and capital markets. These legal services also shelter APIF and its Regulated Utilities from operational risks.

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PROFESSIONAL SERVICES

Description	Professional Services including strategic plan reviews, capital market advisory services, ERP System maintenance, benefits consulting, and other similar professional services.
Ratepayer Benefits	These professional services ensure that APIF's strategic plans and initiatives are completed with the highest degree of care and professionalism, which is necessary for the Regulated Utilities to receive debt and equity funding from capital markets. These services allow the Regulated Utilities to have an available source of capital funding for plant and infrastructure in the provision of utility services.
Need for Services	These costs are required for the provision of service as the strategic plans are filtered down to the individual utility level. In the absence of strategic plans, the utilities would not be investing to ensure the highest level of service is provided, and would also not be able to strive for continued operational improvements to save ratepayers money in the long run. In the absence of these services, unit holders would not invest in utility operations of APIF because the utilities would not incur the necessary costs to ensure that the strategic plans are followed as a condition of such funding.

2. Access to Capital Markets.

One of APT's primary functions is to ensure APIF's facilities (i.e., the Regulated Utilities) have access to quality capital. APIF is listed on the Toronto Stock Exchange, a leading financial market. In order to allow the Regulated Utilities to have continued access to those capital markets, APT incurs the following Costs for the benefit of the Utilities. These services and costs are a prerequisite to the Regulated Utilities' continued access to those capital markets.

LICENSE FEES AND PERMITS

Description	Fees incurred by APT to ensure that APIF can participate in the Toronto Stock Exchange. These licensing and permit fees are required in order to sell units on the Toronto Stock Exchange.
Examples	Sedar fees, annual filing fees, licensing fees, etc.
Ratepayer Benefits and Need for Services	The ratepayers and Regulated Utilities have access to capital so long as APIF is able to access capital markets. These license fees allow APIF to sell units on the Toronto Stock Exchange and, in turn, provide funding for utility operations. These license fees incurred by APT are critical to ensure continuing access to capital.

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ESCROW FEES

Description	Escrow Fees for payment of dividends to Unit Holders.
Examples	Unit holders invest in APIF, and, in turn, provide capital funding to the Regulated Utilities by buying units. In making those investments, unit holders expect monthly distributions on the units they own. As such, APT incurs escrow fees in paying such monthly payments to unit holders.
Ratepayer Benefits	Escrow Fees are incurred in order to ensure that unit holders of APIF continue to maintain ownership, and that new shareholders are enticed to invest in the Fund. Those new shareholders are the ones truly investing money for new and future projects the utilities undertake. Without them, there is no money for APIF to invest in the utilities.
Need for Services	Escrow Fees are incurred to ensure continued access to capital and ensure continuing and ongoing investments by unit holders. Without such escrow fees, the Regulated Utilities would not have a readily available source of capital funding.

UNIT HOLDER COMMUNICATIONS

Description	Unit holder communication costs are incurred to comply with filing and regulatory requirements of the Toronto Stock Exchange and meet the expectations of shareholders.
Examples	News releases, unit holder conference calls, etc.
Ratepayer Benefits	Unit holder communications costs are incurred by APT for the benefit of the Regulated Utilities to ensure that unit holders are fully informed of all operational and strategic decisions. These disclosures are required by law to ensure a level of integrity and rigor is applied to the management of the Regulated Utilities.
Need for Services	In the absence of unit holder communication costs, investors would not invest in the units of APIF, and in turn, APIF would not have capital to invest in the utilities. Without such communications services, the Regulated Utilities would not have a readily available source of capital funding.

3. APT Financial Controls.

Financial Control costs incurred by APT include costs for audit services, tax services, and trustee fees. These costs are necessary to ensure that the Regulated Utilities are operated in a manner that meets audit standards and

**LIBERTY WATER AFFILIATE
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regulatory requirements have strong financial and operational controls, and that financial transactions are recorded accurately and prudently. Without these services, the Regulated Utilities would not have a readily available source of capital funding.

AUDIT FEES

Description	Audits are done on a yearly basis and reviews are performed quarterly on all facilities owned by APIF on an aggregate level.
Examples	Audits are provided by KPMG.
Ratepayer Benefits	Audits benefit ratepayers by verifying and ensuring that all financial transactions are recorded prudently. Further, financial transactions are scrutinized to ensure that operations are run prudently. Audit fees also ensure that access to capital is available as it is a requirement of financial markets. The aggregate audit again benefits the Regulated Utilities by allowing continued access to capital markets and unit holders.
Need for Services	These corporate parent level audits reduce the cost of the stand-alone audits significantly for utilities such as LSPSCO, which must perform its own separate audits. Where stand-alone audits are not required, rate payers receive benefits of additional financial rigor, as well as access to capital, and financial soundness checks by third parties. Finally, during rate cases, the existence of audits provides Staff and intervenors additional reliance on the company records, thus reducing overall rate case costs. The aggregate audit is necessary for the Regulated Utilities to have continued access to capital markets and unit holders.

TAX SERVICES

Description	Tax Services expenses are incurred to ensure prudent tax filing, planning and management.
Examples	Taxes are paid on behalf of the Regulated Utilities at the parent level as part of a consolidated United States tax return. Tax services are provided by third parties, including KPMG for tax planning and filing.
Ratepayer Benefits	Tax services ensure that each utility maintains tax compliance as the parent maintains compliance on its behalf. The shared cost of such tax services also are lower than the costs of stand-alone tax services, which would otherwise be incurred by the Regulated Utilities.

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Need for Services	Tax services are required as each of the utilities would be required to pay taxes on a stand-alone basis. Filing tax returns on a consolidated basis benefits each Regulated Utility by reducing the costs that otherwise would be incurred by such Utility in filing its own separate tax return.
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TRUSTEE FEES

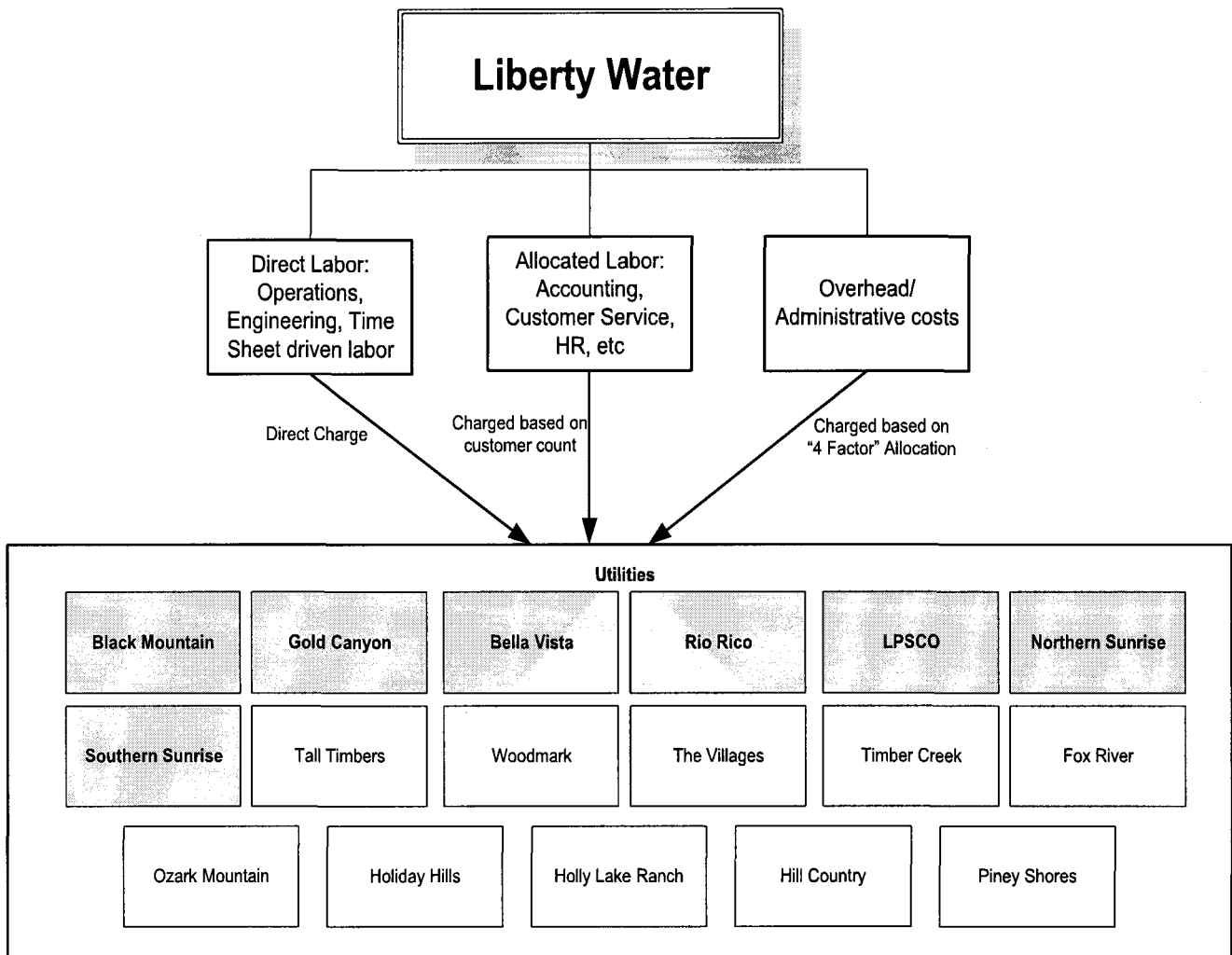
Description	Trustee Fees are paid to the Board of Trustees, which meets on a quarterly basis.
Ratepayer Benefits	Trustees act in the same manner as Boards of Directors. They have a duty to shareholders to ensure that they will act in their best interests. This means that they must act in a way that optimizes the operations of the utilities. Trustees also approve the strategic direction of the company, provide corporate governance, and oversee the strategic direction and health of the Income Fund, and in turn the Regulated Utilities owned by APIF in order to ensure long term sustainability. In summary, the trustees help to ensure financial rigor, significant controls, and ultimately keeps rates low.
Need for Services	Trustees are required to oversee the operations of the utilities collectively. They also ensure on going access to capital and are a fundamental requirement for a publicly traded company and its affiliates.


4. APT Administrative Costs.

Finally, administrative costs incurred by APT such as rent, depreciation of office furniture, depreciation of computers, and general office costs are required to house all the services mentioned above. Without these administrative costs, the employees of APT could not perform their work and provide the necessary services to the Regulated Utilities.

LIBERTY WATER AFFILIATE COST ALLOCATION METHODOLOGY

Appendix 1: Overview of Liberty Water Allocation Methodology



 Utilities located in Arizona

Appendix 2: Sample Time Sheet of Liberty Water Employee

SIGNATURE

SUPERVISOR

**LIBERTY WATER AFFILIATE
COST ALLOCATION METHODOLOGY**

Appendix 3: Overview of APT Cost Allocations:

